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The effects of an earthquake are, in part, a function of the strength of the original shocks, in part a function of the strength of the buildings affected.

—The Great Depression, Lionel Robbins
Macmillan & Co., Ltd., 1934

Wall Street, A House of Cards

What, exactly, is ailing the global economy in the first place? So far, we are not aware of any serious discussion of its causes. There is obviously far more surprise and confusion than worry, policymakers included. There is a general inclination to fault the contagion from the Asian and the Russian shocks, but a general reluctance to naming the true underlying cause: The world's greatest financial bubble, created by the Western financial system, is bursting, leaving behind a legacy of unprecedented dislocations in the world's financial systems and economic structures. Entire economies have been ruined by this bubble.

For more than a year, the Greenspan-Wall Street alliance has been feeding the public with the happy message that the Asian "flu" would on balance beneficially affect the U.S. economy. By preventing it from overheating, the Asian flu would bring the U.S. economy lower inflation and interest rates. In joyous response, the stock markets took off to a new spurt early this year. The front-runner, though, was European stocks, basking in the bull story that corporate management in Europe, confronted with the fast approaching common currency, was eagerly learning and applying American "shareholder value" magic to the benefit of profits, while Wall Street euphoria had already begun to be encumbered by unexpected profit warnings.

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Abruptly, Mr. Greenspan has changed tone. Speaking on a day, when the dollar endured its sharpest ever fall against the yen, an almost 10 percent drop, Greenspan admitted that in almost 50 years of monitoring the US economy, "I've never seen anything like this. What is occurring is a broad area of uncertainty or fear. When human beings are confronted with uncertainty, meaning they do not understand the terms of particular types of engagement they're having in the real world, they disengage. And in markets, disengagement, of necessity, means that prices fall. In other words, fear itself is something to be frightened of. It harms markets in its own right."

Mr. Greenspan is right. The present global liquidity collapse and credit crunch are different from anything experienced in the postwar period. They are of unprecedented virulence and breadth. Moreover, these upheavals are occurring against the backdrop of lower inflation and continuous loose monetary policies, while setbacks in the past were always triggered by monetary tightening when the business cycle was overheating.

While most of the developing world is already afflicted by a full-blown credit crunch, the industrial countries have seen a sudden, dramatic rise in credit spreads—or the risk premium—on debts of lower-grade borrowers. This implies growing funding difficulties for less creditworthy borrowers. However, there is a

distinct difference in this respect between Europe and America. The biggest trouble spot for the world economy is now the U.S. credit markets, particularly the heavily leveraged $3.4 trillion market for mortgage-backed and asset-backed securities.

LIQUIDITY CRUNCH

Still, this strange experience of collapsing liquidity in the face of monetary looseness is by no means unprecedented. But to find a meaningful parallel, we have to go back to the early 1930s. What happened then, and what is happening today, is the bursting of a global financial bubble, with emphasis on the word global. Another striking parallel between then and today is that, in both cases, the global bubble had its epicenter in the US financial system. Japan experienced in the early 1990s the bursting of a disastrous bubble ravaging its economy, but it was not global.

The financial meltdown of the 1930s manifested itself in two main features, and so does the present meltdown: The most spectacular events in both cases are the crashing stock markets, but more critical to the length and the depth of the depression in the 1930s were soaring risk premiums and credit spreads and the collapse of new lending to all but the most highly rated borrowers.

Conveniently, laying specific blame for the present crises—such as pointing to Asia's troubles—distracts attention from the decisive common cause behind the whole variety of collapses: the shattering of the greatest speculative bubble the world has ever seen.

In reality, there never was a specific Asian crisis. All along it has been a global crisis, which happened to start in Asia. The region's crisis was catalyzed by rising doubts about the sustainability currency pegs with the dollar. Flight of hot money in conjunction with soaring hedging positions against the falling currencies and, later, heavy speculative trading broke one currency peg after the other. To peg a high-yielding currency to the dollar is suicidal, because Wall Street is sure to take reckless advantage of any interest spread, unbalancing such economies and their financial systems with a deluge of money.

THE WAKE-UP CALL: LTCM

A series of disasters, culminating in the near-collapse of Long-Term Capital Management, the U.S. hedge fund, has finally shaken the prevailing complacency and thrown the spotlight back to where it belongs: onto the Western financial system and the speculators who leveraged financial bets to the point of absurdity.

In their testimony on LTCM, both Fed Chairman Alan Greenspan and William J. McDonough, head of the Second District Federal Reserve at New York, defended their rescue action for the hedge fund with the argument that "an abrupt and disorderly close-out of Long-Term Capital's positions would have posed unacceptable risks to the American economy."

Now, please consider this monstrosity. One single hedge fund with less than $3 billion in owned equity capital was freely allowed to build up positions in stocks and bonds of $160 billion, plus derivatives with a notional value of more than $1 trillion—adding up to about 240 times gearing. Yet, according to the Fed, the sudden unwinding of these positions would have endangered the stability of the U.S. economy and its financial system. This is worse than criminal, it is ludicrous.

Reading the testimonies of the two top officials, it did strike us that both spoke with considerable respect of the sophisticated investment strategy of LTCM and the enormous returns they have delivered in the last three years. All too clearly, though, it was by no means sophisticated judgment but the extreme leverage that delivered

the spectacular returns. This rather reminds of a phrase written by Walter Bagehot more than a century ago about events that usually lead to a financial crisis: "One thing is certain: at a certain time, a great amount of stupid people come into a great deal of stupid money."

TOO MUCH HIGH-TECH, TOO LITTLE UNDERSTANDING

People watching the market value of their stocks dropping like a stone, ask themselves in desperation, how such a sudden global disaster was possible in a world apparently running so smoothly. Governments, central banks and financial institutions were supposed to possess most sophisticated systems for assessing risks and discovering maladjustments. Yet, they saw absolutely nothing coming. Our answer is that high tech and sophisticated mathematical models are one root cause of the current disaster. They engendered the hubris that lured banks, investors and speculators to such unbelievable excesses.

Another root cause of this inability to foresee trouble was the total ignorance of the most basic principles of economic and financial equilibrium. To pass judgment on whether an economy is growing in healthy balance or is unhealthy, one needs a firm notion of what the essential requisites of economic and financial equilibrium are. Very, very few have this guidance today.

The notion of equilibrium embraces many elements: equilibrium in the balance of payments, the balance between prices and costs, the relation between income and debt growth, etc. But this conception of equilibrium focuses above all on the balance or imbalance between two aggregates: new savings and new credit. All major economic and financial disasters have had their main source in major imbalances between these two.

It all boils down to two simple questions: Is a limit to credit expansion needed? and what is the limit? Knowledge of this limit used to belong to the basics in economics. It says: Sound credit is limited to available savings. The savings release resources for use by the borrower, and to keep the two aggregates in equilibrium is the function of interest rates. If rates are too high, lagging credit demand will lead to recession. If rates are held too low, credit expansion overshoots the savings limit, implying boom and inflation. Our apologies for this recapitulation of elementary economics, but we owe this global financial mess to the fact that the financial community has completely lost sight of it.

Putting it concisely: There is today unprecedented sophistication in market techniques but unprecedented ignorance in fundamental economics.

First a look at the U.S. figures:

TOTAL NET BORROWING, ANNUAL INCREASES IN $ BILLIONS

	1993	1994	1995	1996	1997	IV97	* I98*
Federal Government	256.1	155.9	144.4	145.0	23.1	40.8	- 30.0
Households	205.9	309.3	348.9	372.7	350.3	388.0	426.9
Business	51.3	141.7	245.5	195.8	311.3	406.0	419.7
Financial Sector	294.4	468.4	456.4	556.2	649.2	971.7	828.5
Total Borrowing	*952.2*	*1028.9*	*1230.2*	*1354.5*	*1464.9*	*1940.5*	*1830.0*
Personal Savings	210.3	176.8	179.8	156.5	121.0	73.0	35.3
GDP Growth	313.7	388.9	322.6	329.0	449.3		

*at annual rate for the quarter

To speak in the face of these figures of an imbalance between savings and credit in the United States is a gross understatement. Credit ludicrously outgrew private savings. In the first quarter of 1998, a credit expansion of $ 1.8 trillion compared with $ 35 billion of new personal savings. While private credit and debt growth doubled and trebled, personal savings collapsed. Plainly, a mixture of exploding credit and vanishing savings makes for very strong economic growth. But they glaringly signal an economy and financial system that has outrageously run out of control.

"Taking the falling inflation rate as a life insurance for permanent monetary looseness, they embarked on a massive expansion ending in a fantastic financial leveraging binge."

It is now painfully obvious that there was nothing in the thinking of international financial leaders or in the workings of the current international financial system to prevent the excesses that have fueled this global boom in the credit and stock markets. We were always aware that this failure had two main reasons:

One was the traditional narrow focus in the United States on consumer and producer prices as the one and only indicator of underlying inflationary pressures. Blinded by this flawed concept, policymakers and everybody else ignored the horrifying credit figures. This approach had more or less badly worked in the 1970s and 1980s when expanding credit used to go overwhelmingly into economic activity and product prices. When these rose, the central banks hit the brakes. It was a bad system, but it was good enough to avoid catastrophe.

The second reason for this myopia was ridiculous faith in the perfect self-regulation of free markets. On Sept. 16, Mr. Greenspan still calmly assured a Congress committee that there was no reason to be alarmed by the billion-dollar bets of hedge funds with the words: "Hedge funds are very strongly regulated by those who lend the money."

But this pattern of credit and financial flows altered dramatically in the 1990s. The change was of two kinds:

First, there was global money and credit creation of unprecedented magnitude; second, the resulting deluge of money and credit flows changed direction towards the financial markets.

While inflation in product prices subsided, it skyrocketed in the financial markets, showing surging stock prices, falling credit spread, and increasing leveraged speculation concentrated on high-yielding credit. Given, however, the prevailing convention to measure inflation exclusively by rises in product prices, the central banks kept their monetary spigots wide open, allowing and fostering the developing credit-driven financial mania.

Wall Street and Co. saw the green light. Taking the falling inflation rate as a life insurance for permanent monetary looseness, they embarked on a massive expansion ending in a fantastic financial leveraging binge. With a plethora of financial innovations and highly efficient new computer and communication technology, Wall Street's global reach exploded and nonbank financial institutions proliferated in the United States. Heavily leveraged, collateralized asset-financing and speculation ran rampant.

WHAT KIND OF EFFICIENCY?

There is a lot of boasting about the singular efficiency of the US financial system. For sure, it has no parallel. But efficiency in what and for what, that's the pertinent question. Unfortunately, too much of Wall Street's energy and efficiency is directed at pure financial speculation at the expense of financial and economic

stability. In actual fact, Wall Street's institutional infrastructure has become far too big to make a living just on financing economic growth. Fostering and managing unfettered global speculation, has essentially become the main business.

In competition with the banking system, Wall Street has aggressively promoted securitization as a way to package and sell "asset-backed securities" or "mortgage-backed" securities" to investors. This credit system of marketable loans which exploded in the past years, has been widely regarded as one of the greatest achievements of Wall Street, supposedly enhancing competition and market efficiency.

Rubbish. The weak feature of this new credit mechanism is the way that the holdings of the created securities are actually financed. They are generally funded outside the banking system, partly through the bond market but—and this is what makes it an extremely hazardous credit mechanism—overwhelmingly by means of heavily leveraged tapping into the money market.

Importantly, such credit creation outside the banking system—either through asset-backed securities or through specialized nonbank financial institutions—does not involve a corresponding creation of money supply in the form of bank deposits, as bank lending does. Rather than increasing the money supply, it increases money velocity. All in all, this kind of leveraged credit creation has several undesirable monetary consequences:

First, securitization has immensely enlarged the potential for credit creation in the United States; second, it has led to ruinous competition among the issuers at the expense of credit quality; third, it is not subject to any regulation or control by the central bank; and fourth, it inherently promotes excess credit creation leading to busts. In periods of substantial interest rate spreads, this credit system tends to great excess. However, its heavy dependence on short-term money and high leverage makes it extremely vulnerable to any monetary tightening or rise in liquidity preference of investors and lenders. In short, it is a credit system that has all the qualities of a house of cards.

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America's very first experience with this kind of collateralized short-term lending outside the banking system was in the late 1920s with the famous broker loans. They were the first sector to collapse as the manic era unwound. To prevent immediate disaster, the commercial banks had to take over a large part of these loans.

Large parts of this huge market of securitized loans have suffered sharp increases in spreads, inflicting devastating losses on the heavily leveraged institutions that originate these loans. A slew of these lenders that went public at lofty multiples crashed and burned this year.

By the way, Europe doesn't have this problem of collapsing market liquidity for the simple reason that governments and central banks have never allowed the development of this unstable financial structure.

In the same vein, it is argued that the hedge funds and the proprietary trading desks of banks with their sophisticated strategies tend to improve the efficiency of the markets by exploiting anomalies in market prices. If that's the great positive aspect, it is definitely outweighed by the very negative effect that the hedge funds and bank traders operate with enormous leverage—which essentially implies heavy distortion in market prices.

Consider the prodigious leverage volume of LTMC alone. A financial system, in which one nonbank institution is able and allowed to gear an equity base of less than $5 billion to an asset position of $125 billion plus $1.25 trillion in derivatives, such a financial system is plainly and simply not efficient, but insane. Not surprisingly, all the troubles are coming from those market-financed, heavily leveraged institutions.

RISK AVERSION OR BURSTING BUBBLES?

As markets have cracked, one after the other, the ready, comforting explanation was heightened risk aversion among investors. Greenspan even described it as the worst he had ever seen. This is not only too simplistic, but actually false. Given so far only a very small outflow from mutual funds, most small and medium investors have obviously stayed put. Besides, this explanation tends to suggest that the markets and the economies are, basically, in good shape, except for the development of such unusual risk aversion. Another comforting inference of this explanation is that the only thing needed to overcome this disturbance is to rebuild confidence and break the liquidity preference with a few interest rate cuts.

No, no, no. Credit and leverage-driven financial markets boom—and intrinsically go bust. But the decisive cause of the present global bust does not lie in shocks from Asia or Russia. It definitely lies in the severe financial and economic dislocations, which have developed globally in the prior boom. That's what the instigators of such bubbles have always refused to understand.

To make this absolutely clear: The U.S. economy owes this liquidity crunch in parts of the financial system to nothing other than the unsustainable debt and pricing excesses that have accumulated during the past years. There was a naive belief among supposedly sophisticated speculators that the Fed's loose monetary stance guaranteed perfect liquidity at all times in all markets. Carefully hedged positions blew up, they believed, because the market risks had been miscalculated.

The big selling in the currency and credit markets, has clearly come from the highly leveraged players. But just as obviously they did not deleverage because they were suddenly gripped with risk aversion. They deleveraged because different bets of theirs in the markets had gone wrong, confronting them with actual or potential margin calls from their lenders.

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In other words, a large part if not most of the heavy selling of various assets has been forced selling, which in essence and implications is something pretty different from a mere change in psychology towards risk aversion. Putting it differently, there was too much sophisticated mathematics in the markets and too little thinking.

HAS THE YEN CARRY-TRADE BEEN LIQUIDATED?

The biggest, single blow to the leveraged players and markets has been the abrupt slump of the high-yielding dollar against the low-yielding yen. The dollar dropped, like the rouble, by 15 percent in only two days. A ready and convenient explanation was dollar selling by Japanese investors who were repatriating their capital from the United States. What happened in reality was the sudden, complete slaughter of the famous yen carry-

trade. For three years or more, traders and speculators around the world have funded heavily leveraged asset holdings of diverse kinds and currencies with ultra-cheap yen credits, gaining the benefit of a big positive interest differential plus currency gains on the falling yen.

Instead of marching towards 160, 180, or even 200 yen against the dollar, as had been expected, the yen abruptly reversed course, heading rather for 100 yen. Waiting for this to happen, we warned in the last letter that any unwinding of yen-funded leveraged positions would depress the dollar. Once the yen began to rise in response to any such unwinding, the whole yen-carry-trade bubble became unsustainable, being crucially dependent on a weak or falling yen. In this way, even US and European government bond holdings funded by yen carry trade, fell victim to enforced deleveraging.

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Still, we keep wondering, whether this essentially implies its complete unwinding. Nobody knows the size of this play. But it is sure to have run into quite a few hundred billion dollars.

As the yen surged, it certainly was suicidal to maintain any yen carry trade. But in order to repay the yen loans, the leveraged players had first to liquidate their dollar assets. Considering the sudden liquidity collapse in the markets for higher-yielding securities, we suspect that many players in yen carry trade may have been trapped. In short, stuck by the illiquidity of their dollar assets, these speculators are stuck with a yen indebtedness that has been soaring in dollar value. There could well be another disaster looming.

DOES MR. GREENSPAN UNDERSTAND?

Greenspan, the world's most powerful banker has for most of his 11 years in office been regarded with increasing awe and admiration usually reserved for great national leaders or war heroes. During the last three or four years of the roaring bull market in stocks, in particular, he gained the gloriole of being a central banker close to impeccability, who played a key role in delivering the "new paradigm" U.S. economy with unprecedented wealth creation, permanent strong growth, low inflation and fabulous corporate profit growth.

We have always looked askance at Mr. Greenspan. Over time, he has repeatedly said things about the markets and the economy which made us doubt that he understands the essentials of economic equilibrium. There must be a misunderstanding, we thought. But any such doubts have been dispelled by what he said in the course of a recent Congressional testimony. Here is the top central banker in the world, who still raves about the "new paradigm" U.S. economy. Actually, he virtually glorified the "new international financial system" with its high-tech sophistication for its ability to put scarce savings to their potentially most productive use.

Obviously, Mr. Greenspan is at a complete loss to realize the appalling distortions which the unfettered speculative excesses of the past years, overwhelmingly driven by heavy financial leveraging, have inflicted on the global financial system and further on the underlying economies. Some of what he said, is so unbelievable that one has to read it:

As I have indicated in earlier presentations, the dramatic advances in computer and telecommunications technologies over the last decade have fostered a marked increase in the degree of sophistication of financial

products. A vast new array of debt, equity and hybrid instruments, as well as newly crafted derivative products have fostered an unbundling of risks, which, in turn, has enabled investors to optimize (as they see it) their portfolios of financial assets. This has engendered a set of market prices and interest rates that have guided business organizations increasingly towards producing those capital investments that offer the highest rates of long-term return, that is, those investments that most closely align themselves with the prospective value preferences of consumers. This process has effectively directed scarce savings into our most potentially valuable productive capital assets. The result, especially in the United States, where financial innovations are most advanced, has been an evident acceleration in productivity and standards of living, and, owing to the financial sector's increased contribution to this process, a greater share of national income earned by it over the past decade.

The new financial innovations [sic], which have spread at a quickened pace, have facilitated a rapid expansion of cross-border investment and trade, and almost surely, as a consequence, a significant increase in standards of living for those nations that have chosen to participate in can appropriately be called our new international financial system. The system is new in the sense its dynamics appear somewhat more accelerated relative to the international financial structure of, say, fifteen or twenty years ago. Owing to the new technologies, market prices have become more sensitively tuned to subtle changes in preferences and, hence, react to those changes far faster than in previous generations. The system is productive of increased standards of living and innovation but also to discipline the mistakes of private investment or public policy.

Even in the face of worldwide crashes, Greenspan still raves about the extraordinary efficiency and sophistication of today's markets. He clearly shares the blind belief of the "free market" apostles among American economists that markets, left to their own devices, essentially behave in perfection by moving incessantly to equilibrium.

We have always regarded this doctrine as the absolute bottom in the history of economic thought. It is blatant nonsense for the simple reason that it completely ignores potentially distorting monetary influences. Market forces, by themselves, are unable to maintain equilibrium and to properly allocate resources if monetary policy is too loose or too tight. The key to market balance and discipline is held by monetary policy, and nothing else. It's frightening to realize that the world's financial leader doesn't even know this elementary truth.

At issue, here, is the question, whether unfettered financial leveraging, in other words, virtually unlimited lending and borrowing for the acquisition of financial assets, as has been practiced in the last years, is compatible with economic and financial stability? Our categorical answer is, "naturally not." The monstrous extent to which leveraging actually been employed in the global markets, U.S. markets in particular, of late, this has essentially caused immense distortions in prices, exchange rates and economic structures. Correcting these distortions is sure to take a long time and cause a lot of pain.

THE UNITED STATES' PREDICAMENT

The Fed's second rate cut in October and the prospect of more of the same to follow soon, has had an enormous psychological effect, propelling a worldwide sharp rally in stock markets and a general, moderate narrowing of the drastically widened yield spreads. Not surprisingly, many Wall Street pundits have been quick to proclaim that the worst is over. Since they never understood the true cause of this global crisis in the first place, don't take them seriously.

Greenspan had to respond to collapsing liquidity in large parts of the U.S. financial markets. The situation threatened to turn into a self-reinforcing meltdown as many highly leveraged players were caught in forced liquidation. Trading and issuing virtually stopped in a wide range of markets.

Wall Street takes it for granted that Mr. Greenspan has both the tools and the wisdom to engineer a gradual unwinding of the global financial bubble, thereby avoiding a U.S. recession. We think, he possess neither of the two. The U.S. economy is in big trouble. It is being hit by three powerful contractionary forces: massive, destructive deleveraging of past excesses, a systemic funding crisis and a growing profit squeeze.

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While the Fed is easing, the markets have been tightening through surging credit spreads and a sharp decline in new issuance. Spreads on investment grade corporate securities widened 35 basis points in a single day to levels not seen in 10 years. Spreads in the $430 billion junk bond market widened to a stunning 645 basis points, more than doubling since early summer to levels not seen since the recession and acute financial stress of 1991. Reports were of almost total illiquidity with meaningful trading in only about 10 names and with actual sales for many junk issues possible only at prices considerably below stated bids. Even more ominous, mortgage spreads expanded to the widest levels since 1986 and markets for many of the more esoteric mortgage derivative instruments, exactly the securities held by many failing speculators, literally disappeared.

FINANCIAL ANARCHY

Just one day prior to the Fed's Oct. 15 rate cut, BankAmerica reported very disappointing earnings as well as a quite disturbing revelation of the failure of a most egregious speculation. While we have in past letters pointed to BankAmerica's dubious move into risky ventures, the recklessness of its arrangement with private securities dealer/hedge fund/derivatives player D.E. Shaw perplexed even us. In a growing list of acts of lunacy that seem virtually endemic to the US credit system, BofA "lent" $1.3 billion to D.E. Shaw, which was leveraged to security holdings totaling $40 billion. Similar to LTCM, Shaw was highly regarded for its "black box" strategies and cadre of brilliant "rocket scientists" incorporating the most sophisticated computer models for seemingly riskless outsized returns.

Here too, though, the secret of the previous fabulous returns was huge leverage. With the markets turning against the bets, BofA had to take a $372 million charge and accept direct ownership of the entity's fixed income portfolio including $20 billion of securities as well as large derivative positions. BofA also converted its loan into the only equity supporting the remaining positions of this venture, which included considerable equity and equity derivative exposure. Importantly, BofA must also assume the borrowing obligations used to finance these securities as well as derivative counterparty obligations.

Repeating what we have said many times before, the U.S. financial situation is absolutely out of balance and control, being pervaded with extreme leverage in risky securities. We are tempted to call it financial anarchy. Fears have escalated as to the stability of the repo market, the critical financing vehicle for leveraged speculation. Throughout the mortgage industry stock prices collapsed for dozens of companies with balance sheets bloated with mortgages and mortgage derivatives as the market for these assets collapsed.

TWO SHAKY PILLARS

Within this financial quagmire, two mortgage companies have so far proven immune to the turmoil in the financial markets: the Federal National Mortgage Assoc. and the Federal Agricultural Mortgage Assoc.—Fannie

Mae and Freddie Mac. As nervous investors dumped securities of most highly leveraged holders of mortgages, they have flocked to government-sponsored Fannie and Freddie, and their stocks are now trading at or near all-time highs. Fannie's market capitalization of $67 billion is more than 20 times earnings and a stunning five times book value. Freddie has a market value of $36 billion, fully 24 times earnings and 5.6 times book. Viewed as companies willing to operate aggressively to satisfy Wall Street earnings growth demands, both are mutual fund investment darlings. Fidelity owns 116 million shares of Fannie and 73 million shares of Freddie, more than 10% of both companies.

And just as we warned earlier this year with our profile of the money center banks and the imminent problems associated with their pell-mell expansion of risky operations, we see great trouble building for Fannie and Freddie. While investors celebrated third quarter net income growth of 10% for Fannie and 20% for Freddie, they close their eyes to the explosion in both balance sheets. Undeterred by mounting financial and economic turmoil, both companies are resorting to ever heightened levels of leverage to increase shareholder value. At a conference call this past spring Fannie Mae's CFO's contended he'd "never seen an environment as favorable for Fannie Mae."

"We see in Freddie and Fannie the epitome of "modern Wall Street finance," replete with massive leverage and all the financial engineering concepts not yet tested in difficult times."

The fact is that given the dramatic deterioration throughout the mortgage industry, Fannie and Freddie now act much as the buyer of last resort for mortgage paper. With their debt backed by the US Treasury, both benefit from easy access to credit markets while all other highly leveraged players struggle for survival. However, it is precisely this "favorable environment" that allows the type of egregious expansion that comes back to bite overaggressive lenders, as history has irrefutably demonstrated.

Fannie Mae's total assets at the end of the third quarter total a staggering $455 billion with stockholder's equity of less than $15 billion. For comparison, Fannie ended 1990 with $133 billion in total assets. For the quarter, the mortgage portfolio held on Fannie's balance sheet increased $27 billion, or at an annual rate of more than 30 percent. This compares to a growth rate of 13 percent for last year's third quarter. For the first nine months of this year, portfolio growth has been at a rate of 25 percent versus less than 10 percent last year. Yet, even with this explosive growth, income grew at just over 10 percent as net interest margin on assets contracted sharply to 1.05%, down from above 1.40 percent in 1993. Not only that, reported profits were bolstered by a "negative $15 million provision for losses", in other words, by reducing existing reserves for future losses. Making every endeavor to enhance shareholder value further, Fannie bought back almost 17 million shares of stock so far in 1998.

Looking at Freddie Mac, the ballooning of balance sheet is even more pronounced. Total assets ended the third quarter at $263 billion, growing $33 billion in just three months. For comparison, Freddie had ended 1990 with $40 billion of assets. For the first nine months of 1998, assets have exploded almost $69 billion, or at an annual rate of nearly 50%. Stockholder's equity, at $9.3 billion, leaves the ratio of assets to equity at 28 to 1. Freddie, too, saw its net interest margin deteriorate dramatically. Yet, despite very aggressive expansion and rising risks, provision for losses were drastically reduced.

But overzealous asset expansion is only one troubling aspect. The other one is the liability side of the

balance sheets. In the case of Freddie Mac, fully 92% of the dramatic asset growth has been funded by increased short-term debt. During the third quarter, in fact, debt due within one year expanded by $37 billion to $148 billion while long-term debt contracted $4 billion to $84 billion. Surely, memory of the savings and loan debacle born from funding long-term mortgages with short-term debt should not have completely faded.

Granted, both Freddie and Fannie are major derivative customers of Wall Street and raise claim to sophisticated models and strategies protecting them against interest rate moves, both higher or lower. But considering recent revelations of the gross failure of computer hedging models we are even more dubious of such claims. Furthermore, in the event of a systemic crisis, which we see as increasingly likely, derivative strategies would prove largely ineffective due to counterparty defaults. Indeed, relying on derivative contracts with Wall Street firms to insure against higher interest rates seems to us about as reasonable as contracting with Russian banks to protect against a collapse in the rouble!

We see in Freddie and Fannie the epitome of "modern Wall Street finance," replete with massive leverage and all the financial engineering concepts not yet tested in difficult times. Both depend extensively on interest rate derivatives as well as credit insurance, two products we regard much as phenomenon of the long bull market. At the end of 1997, Freddie claimed that its exposure to credit risk was mitigated by more than $100 billion of credit enhancements or guarantees. Much of this is related to the proliferation of private mortgage insurance that has stoked the housing boom by allowing many new homeowners to buy despite poor down payments. While this "insurance" is a convenient pretense of beneficial credit protection, it will in a serious downturn it will prove almost useless. The defaults of hopelessly insolvent insurers are inevitable.

Basically, the federal collateralized lenders Fannie Mae and Freddie Mac are quite similar to Long Term Capital Management. With a sliver of capital and massive borrowings, a huge portfolio of securities is accumulated to profit from credit and interest rate spreads. In the case of LTCM, "sophisticated" models and strategies thought to provide investors a near riskless perpetual money machine appear in hindsight much more resembling fraudulent ruse. A change in environment with widening spreads quickly led to mark-to-market losses wiping out equity and leading to a funding crisis, bailout and eventual liquidation.

But Freddie and Fannie have two important advantages not afforded LTCM. First, they are not required to mark their portfolios to market levels, indeed they will continue to be the price setter for conventional mortgages as long as they remain the two major mortgage buyers. Second, they have the American taxpayers to make good on their debt. Hence, with a $1.3 trillion pool of risk-averse funds currently domiciled in money market mutual funds, Fannie and Freddie have an almost unlimited funding source.

Still, we doubt that highly leveraged institutions can take funding for granted in the present environment. Not too many months ago, LTCM had likewise perceived unlimited funding availability. Fannie and Freddie having accumulated almost $350 billion of short term liabilities using swaps and other derivatives to hedge interest rate risk. This leaves them, nonetheless, quite vulnerable to eventual funding problems. Some impact is already evident in sharply widening spreads, particularly for longer-term debt. A recent Fannie Mae 3-year note was priced at 49 basis points above Treasury, compared to 11 basis points in March, and a Freddie Mac 10 year bond had a startling 82 basis points spread.

For the two giants together, the assets-at-risk to equity ratio is a staggering 70 to 1. Highly leveraged players, holding instruments in these volatile markets are acutely vulnerable to an accident. There are two obvious threats. One is significant credit losses. The other one is an imminent reassessment of future prospects for these institutions by investors, who may demand ever-higher risk premiums on mortgage-backed securities. After all, we can only warn: Wall Street has built a house of cards.

CONCLUSIONS

The Fed-brokered bailout of LTCM shows the sheer hypocrisy of America lecturing Asia about crony capitalism while apparently practicing it at home. Belatedly, criticism is rightly shifting from the follies of the emerging countries to the follies of Wall Street.

The only thing that separates the U.S. economy so far from a rapid slide into recession is the unrelenting consumer spending binge. As all other demand components are flat or declining, this consumer spending binge is destined to evaporate, sooner rather than later. A savage conjunction of liquidity and profit squeeze is hitting the economy.

Japan's economic conditions continue to deteriorate. Not a single demand component is recovering. The rise in net exports comes mainly from shrinking imports. Business fixed investment is declining sharply. Public investment seems to have bottomed out. Private consumption has not yet shown a recovery despite the income tax reduction. Japan is in full-fledged deflation with slumping profits.

Put protection of capital ahead of enhancement of capital. Forget about inflation. The future belongs to a prolonged period of deflation all around. Asset prices will be particularly hit, except for first-rate government bonds.

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